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SUBJECT: AZERBAIJAN: FINANCE MINISTER DISCUSSES ECONOMIC REFORMS AND PLANS FOR MODERNIZATION

Classified By: AMBASSADOR ANNE E. DERSE PER REASONS 1.4 (B, D).

¶1. (C) SUMMARY: During a May 29 meeting with Deputy Assistant to the Vice President for National Security Affairs Joseph Wood and Ambassador Derse, Minister of Finance Samir Sharifov stated that Azerbaijan's economy was expanding rapidly and that as a result inflationary pressures were increasing. He told Wood that the government was moving forward in its efforts to improve the social and physical infrastructure of the country, including reforming the health care and education sectors. Sharifov explained to Wood Government of Azerbaijan (GOAJ) plans to reform the domestic energy sector, improving overall efficiency while providing higher quality services to the public. Sharifov highlighted the important connection between the Oil Fund and the state budget, noting the looming issue of decreasing tax revenues and the growing temptation to draw down Oil Fund assets. Regarding corruption, Sharifov said that Azerbaijan was in a "difficult situation" and that the lack of knowledge regarding correct procedures enabled corruption and bribery to thrive. END SUMMARY.

¶2. (C) In a May 29 meeting with Deputy Assistant to the Vice President for National Security Affairs Joseph Wood and Ambassador Derse, Finance Minister Sharifov briefed on Azerbaijan's efforts to modernize its social and physical infrastructure, deregulate the domestic energy market and effectively use its energy revenues. Wood told Sharifov that the Vice President appreciates Azerbaijan's strategic choice of integration with the West and its regional importance and that he was traveling in the region to get the "Azerbaijani perspective." In addition, Wood said that Azerbaijan had made an important decision to shift its energy and economic policies towards the West.

¶3. (C) Minister Sharifov briefed Wood on Azerbaijan's economic situation, highlighting the country's rapid growth -- the fastest in the world in 2006. Sharifov expressed concern over possible "overheating" in the economy and recognized that inflationary pressures were increasing. He characterized higher inflation as what the GOAJ "expected" and a period that the government needed to deal with in the short-term in order to expand and diversify the economy.

¶4. (C) Sharifov told Wood that the GOAJ was implementing a modernization program to improve social and physical infrastructure, including reforming the health care and education systems. He briefed Wood on the GOAJ's efforts to rehabilitate schools in Baku and the rural areas, noting that many schools were in "bad shape." Sharifov said that the President made improving the education system a priority and that the Finance Ministry was studying a project to give schools more financial independence.

¶5. (C) Turning to Azerbaijan's efforts to improve its

health-care system, Sharifov stated that the GOAJ was working with the World Bank to implement a pilot program in five districts of Baku to improve health-care services. While recognizing that the state could not provide all health-care services, Sharifov stated that the GOAJ was studying a health-care scheme in which the government paid for some services. He told Wood that there would be a Presidential decree in June outlining the new health-care reforms.

¶6. (C) On physical infrastructure projects, Sharifov explained to Wood the GOAJ's plans to ensure energy security, including crude oil and gas production. He said that while Azerbaijan was ready to purchase supplies to ensure domestic needs, the country was not prepared to buy "at any cost" and would not be "blackmailed" by any exorbitant demands. Sharifov, noting Azerbaijan's difficult geographic location, gave as an example Gazprom's unilateral decision to cancel a contract with Azerbaijan and then demand a higher price for gas in 2006.

¶7. (C) Turning to the domestic energy market, Sharifov briefed Wood on GOAJ plans to improve the country's electric infrastructure and build new power generation capacity. Sharifov said that Azerbaijan's fast economic growth and improving living standards demanded a reliant and efficient domestic energy system. He said that the GOAJ planned to build two new power stations at Sangachal and Alibayramli. Sharifov explained that the GOAJ also planned to implement an electric usage metering system to improve tariff collection, while educating the public on its responsibilities to pay utility bills. Sharifov stated that the government's goal in the domestic energy market was to "create a free market system of public utilities."

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¶8. (C) Sharifov recognized the difficulty in changing the public's perceptions and culture regarding the role of the state. He explained how the former Soviet system had shaped Azerbaijanis to "cheat" the system in order to survive and that changing this mentality would take time. He stated that the GOAJ needed to educate the public on the role of the state in the public sphere, including in health care. Sharifov told Wood that the government would like to find a "balance" between government and private interests.

¶9. (C) Comparing Azerbaijan and Georgia's health care reform progress, Sharifov noted that Azerbaijan had begun later than Georgia and that the former minister of health (now in jail) had blocked all possible reforms. He indicated that there were some advantages, as well as disadvantages, to getting a late start, adding that reform was "not simple." Sharifov noted that Azerbaijan could learn from other countries' mistakes and implement a program designed to meet Azerbaijan's needs. He added that the Ministry of Finance was closely involved in reform efforts since they would be financed by the government.

¶10. (C) Regarding Azerbaijan's aspirations to accede to the World Trade Organization (WTO), Sharifov cautioned that Azerbaijan's non-energy economy was not "competitive" and could be "adversely affected" by eventual WTO membership. He stated that the economy was not strong enough or diverse enough to compete globally, adding that Azerbaijan principally exported crude oil and natural gas. In addition, he stated that the GOAJ had not seen the advantages of WTO membership. Despite his concerns, he told Wood that the GOAJ was "working on WTO membership" but that it would not be an "easy path."

¶11. (C) Sharifov told Wood that the State Oil Fund had won a United Nations public service award for all its efforts to provide for future generations. He stated that the Oil Fund had selected Thompson Financial to provide it with software services to expand the fund's portfolio allocation. Sharifov said that a new law on the Oil Fund had been drafted and

would be sent to the President for his approval and then to Parliament. The Oil Fund will diversify its portfolio to include more long-term securities, while preserving an allocation for emergency needs.

¶12. (C) Sharifov highlighted the important connection between the Oil Fund and the state budget. He said that with tax revenues decreasing in the coming years due to the profit sharing shift, the GOAJ could be tempted to draw down Oil Fund assets. Sharifov cautioned that the government would need "to reduce its dependence on the Oil Fund" and find other means to finance future budgets, including by reducing fiscal spending.

¶13. (C) Despite Azerbaijan's rapid economic growth, Sharifov stated that the GOAJ needed to spur non-energy sector growth. He said that the 12 percent growth in the non-energy sector in 2006 was "not bad" but that the GOAJ needed to use the resources in the Oil Fund to shift the balance within the economy in order to strengthen non-energy sectors and make them more resistant to shocks. This shift would also reduce Azerbaijan's dependence on its energy revenues.

¶14. (C) Turning to GOAJ efforts to combat corruption, Sharifov said that Azerbaijan was in a "difficult situation" and that the lack of knowledge regarding correct procedures enables corruption and bribery to thrive. Sharifov agreed with Wood that transparency was the difference between "corruption and transaction costs." For that reason, Sharifov noted, the GOAJ was trying to make the system more transparent so the public understood what forms and payments were required for different services. He stated that the GOAJ was in the process of creating a "one-stop-shop" for businesses to open and register with the government. Sharifov recognized that procurement remained a "big issue" for the GOAJ and that the planned new law on state procurement would help improve government efforts. Sharifov highlighted that the GOAJ was working to minimize problems and improve transparency. In the end, Sharifov felt, the government was moving in the right direction.

¶15. (U) This cable was not cleared by Deputy Assistant to the Vice President Wood.

DERSE